

*United States Court of Appeals
for the Second Circuit*



APPELLEE'S BRIEF

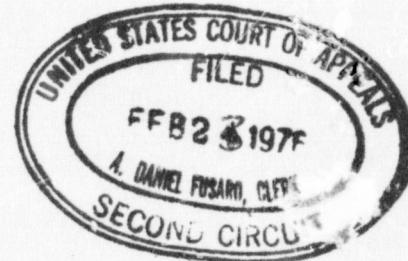
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UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

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THE EXCHANGE NATIONAL BANK OF CHICAGO, :
Plaintiff-Appellee, :
-against- :
TOUCHE ROSS & CO., :
Defendant-Appellant. :
----- x

Appeal from the United States District Court
For the Southern District of New York

BRIEF FOR PLAINTIFF-APPELLEE



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Preliminary Statement

This is an appeal from an order of Hon. Inzer B. Wyatt (A224-A225), which denied defendant Touche Ross & Co.'s motion to dismiss for lack of subject matter jurisdiction. Judge Wyatt held that the District Court had jurisdiction of the dispute because the subordinated notes of Weis, Voisin & Co., a securities broker-dealer, which are held by Exchange National Bank, are "securities" within the meaning of the Securities Act of 1933 and the Securities Exchange Act of 1934. The supporting opinion (A223) has not been officially reported.

Statement of Issues Presented For Review

The sole question upon which this Court granted defendant Touche Ross & Co. permission to appeal is whether the subordinated notes purchased by plaintiff Exchange National Bank are "securities" within the meaning of the Securities Act of 1933 and the Securities Exchange Act of 1934.

Statement of the Case

- A. The nature of the case, the course of proceedings, and its disposition in the Court below.

This action was commenced by Exchange National Bank of Chicago ("Exchange National Bank") in May of 1974 in the United States District Court for the Northern District of Illinois (A3; references using the prefix "A" are to pages of the Appendix). The complaint alleges that defendant Touche Ross & Co. ("Touche") violated provisions of the Securities Act of 1933, the Securities Exchange Act of 1934, and the rules and regulations issued pursuant to those acts, when it certified false financial reports of Weis, Voisin & Co. ("Weis"), a brokerage firm which is now being liquidated under the aegis of the Securities Investor Protection Corporation ("SIPC").* In July of 1972, in reliance upon those false certifications, Exchange National Bank purchased three subordinated notes issued by Weis (Notes at A90-A116).

Upon a motion by Touche, the action was transferred to this Court pursuant to 28 U.S.C. § 1404(a) in January of 1975. After that transfer, Touche moved to dismiss the complaint for, among other reasons, lack of subject matter jurisdiction, thus raising the issue -- decided in the

* The complaint also alleges a pendent claim, not involved upon this appeal, of common law negligence and gross negligence (A11).

affirmative by Judge Wyatt -- of whether the notes purchased by Exchange National Bank in reliance on Touche's false certifications were "securities" (A15).

Both plaintiff and defendant submitted affidavits on the jurisdictional question and fully briefed the issue. Subsequently, "[a]fter full oral argument," Judge Wyatt denied Touche's motion as to subject matter jurisdiction on the ground that the transaction giving rise to the notes was "more in the character of an investment than of a commercial loan" (opinion at A223; order at A224-A225). Judge Wyatt provided the certification required for interlocutory appeal pursuant to 28 U.S.C. § 1292(b), and on November 11, 1975, this Court granted Touche permission to appeal (A227).

B. Statement of the facts relevant to the issues presented for review.

The facts relevant to the jurisdictional issue were set forth in two affidavits submitted below by Exchange National Bank. Touche never actively sought an opportunity to controvert those facts and was content to have its motion decided on the affidavits which are now before this Court. Moreover, Touche's veiled suggestion (Brief, p. 6) that

* Judge Wyatt also denied Touche's motion to dismiss on other grounds "without prejudice to renewal" by Touche (A223-A225).

affidavits may not be considered on a motion to dismiss pursuant to Fed. R. Civ. P. 12(b)(1) is unsupportable. 2A J. Moore, Federal Practice, ¶ 12.14 at fn. 8-10; Moore v. Gorman, 75 F. Supp. 453 (S.D.N.Y. 1948).

Touche's statement of facts, by constant reference to the transaction as a "commercial loan;" merely assumes the very issue to be decided on this appeal, namely, whether the notes purchased by Exchange National Bank were securities or whether they simply evidenced a normal commercial loan. However, for the purposes of this motion, the record reveals the following uncontroverted facts:

In early March, 1972, the manager of the Tel Aviv office of Exchange National Bank, a national banking association with headquarters in Chicago, Illinois, was approached by the manager of the Israeli office of Weis, a securities brokerage firm having its principal place of business in New York. Weis was a member of both the New York Stock Exchange and the American Stock Exchange and was registered as a broker-dealer with the Securities and Exchange Commission. In the normal course of its business, it bought and sold securities both for its own account and on behalf of customers. The Weis official told the Exchange National Bank manager in Tel Aviv that Weis had an investment opportunity for the

Bank totalling approximately \$1 million. The proceeds of the investment, the Bank manager was told, were to be used to expand Weis' brokerage activities worldwide. Shortly thereafter, responding to the Bank's expression of interest, both the Chairman and the President of Weis went to Chicago to speak with Melvin K. Lippe, who was at that time the Executive Vice President and Chief Administrative Officer of Exchange National Bank. Lippe was not a commercial loan officer for the Bank and his regular duties did not include handling of commercial loans. The Weis representatives neither communicated nor negotiated with any of the Bank's commercial loan officers (A51-A53).

Levine and Leit suggested to Lippe that investment opportunities were available in Weis, which needed additional capital to expand its operations both in the United States and abroad. They did not seek one of the Bank's regular, unsubordinated commercial loans; rather, they told Lippe they envisioned a subordinated obligation which could be included in the calculation of "net capital" pursuant to New York Stock Exchange Rule 325 (A53). They also told Lippe that similar investment opportunities had been offered to -- and accepted by -- other financial institutions (A52-A53). Specifically, they proposed that Exchange National Bank purchase certain subordinated notes of Weis

which they said were prepared by Weis and were based on an approved New York Stock Exchange form (A53-A54).

At the time Weis offered the notes to Exchange National Bank, it disclosed the existence of three virtually identical subordinated notes held by Security National Bank and by Fidelity Corporation which had been issued in February and November, 1971 and in June, 1972 (A54; A60-A89).

It was thought by several officers of Exchange National Bank that the purchase of Weis notes by the Bank would spur a closer relationship between the two organizations and would lead to mutual cooperation and expansion, principally in regard to the Israeli-based operations of both Weis and Exchange National Bank (A53). That cooperation, it was hoped, would include the deposit and clearing of funds by Weis and its customers in Israel through the facilities of the Bank (A53).

In order to determine whether purchasing the notes from Weis would be a sound financial decision, Exchange National Bank requested Weis to forward to it copies of its most recent certified financial statements. Those statements had been certified by Touche, who served as the independent auditors and certified public accountants for Weis (A55-A58).

Pursuant to that request, in early July, 1972, Weis transmitted to Exchange National Bank two documents certified by Touche. One was entitled "Weis, Voisin & Co., Inc./Answers to Financial Questionnaire and Additional Information/May 26, 1972" and the other was denominated "Weis, Voisin & Co., Inc./Report on Examination of Statement of Financial Condition/May 26, 1972." In its certifications within those documents, Touche wrote that it had "examined" them "in accordance with generally accepted auditing standards," and that in its "opinion," they "present fairly the financial position of Weis, Voisin & Co., Inc. at May 26, 1972 . . . in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding period" (A120; A123). On July 19, 1972, in reliance upon those certifications by Touche, plaintiff agreed to purchase for \$890,750 three unsecured, subordinated notes of Weis in an aggregate principal amount of \$1,000,000. (The notes are reproduced at A90-A116).

Unlike a normal commercial loan transaction between a bank and a borrower, the notes were executed not on the Bank's own forms, but on the forms prepared and delivered by Touche. They differed from Exchange National Bank's usual form of commercial loan note (A117) in several significant respects (A54-A55). Most significantly,

the notes subordinated the claims of Exchange National Bank to the claims of Weis' general creditors (Notes, ¶ 2; see, e.g., A90-91). Furthermore, unlike normal commercial loan notes, the approval of the New York Stock Exchange had to be received before the holder could transfer the notes (¶ 12; see, e.g., A97). Third, unlike Exchange National Bank's normal commercial loan, prepayment of the Weis notes is permitted only with the approval of the New York Stock Exchange (¶ 3(a)(i); see, e.g., A92). Fourth, the proceeds of any sale by Weis of its securities must be applied to the prepayment of the notes (¶ 3(a)(ii); see, e.g., A92). Fifth, the Weis notes provided that the noteholder had the right to defend actions against Weis commenced by general creditors within 12 months after maturity of the notes, by counsel of the noteholder's choosing, but at Weis' expense (¶ 5; see, e.g., A95). Sixth, each note matures only upon demand by Exchange National Bank given in writing and six months in advance (¶ 1; see, e.g., A90). No such provisions appear in Exchange National Bank's usual commercial loan note (A117).

Contrary to Touche's signed opinions that the statement of financial condition of Weis and Weis' answers to the financial questionnaire "present fairly the financial position of Weis," those documents were materially false and misleading in numerous respects, which are set forth in detail in the complaint (A7-A9). When these misstatements

were discovered in May of 1973, Weis was suspended from membership in the New York Stock Exchange, and is currently being liquidated. Because the SIPC trustee has indicated that the claims entitled to priority and the claims of general creditors "substantially exceed" the total value of Weis' estate, the subordinated notes purchased by plaintiff are worthless and plaintiff therefore has been damaged in the amount of \$890,750 (A130; A169).

The trustee has also indicated that there were a substantial number of other unsecured subordinated lenders who held Weis' securities similar to those Exchange National Bank holds, in addition to the two lenders - Security National Bank and Fidelity Corporation - of which Weis was originally aware. In fact, in the course of the liquidation of Weis, the SIPC Trustee received claims from 51 lenders whose claims, like those of Exchange National Bank, were subordinated to the claims of Weis' general creditors (A160).

In particular, three other major lenders - All American Life and Casualty Co., O'Hare International Bank, and General United Life Insurance Co. - held notes totalling \$3,000,000 under the terms of a Senior Subordinated Note Agreement dated September 29, 1972 (A133-A157). The terms of that agreement, which are incorporated by reference in

the notes held by those three lenders, are similar to the terms of the notes held by plaintiff: they also provide for subordination to general creditors and limited prepayment rights subject to New York Stock Exchange approval.

The Court files in Weis' liquidation proceeding indicate that all such subordinated notes were treated by Weis as representing capital investments and were not reported as normal commercial loans (A204; A210; A215; A218). As those files indicate, under Rule 325 of the New York Stock Exchange, obligations of broker-dealers pursuant to subordination agreements approved by the Exchange (i.e., transactions exactly like the one at issue here) must be considered part of the firm's "net capital" and specifically excluded from "aggregate indebtedness" -- the balance sheet category which would include normal commercial loans (A192-A199). Increasing its "net capital" was precisely what Weis sought to do by this transaction and, in fact, Weis' own balance sheets and financial statements -- including those certified by Touche -- listed all liabilities subordinated to claims of general creditors (which clearly includes, by their terms, notes such as those payable to plaintiff) under the heading "Subordinated liabilities and stockholders' equity" -- and not under the general liabilities heading under which are listed such items as "short-term bank loans" and "accounts payable" (A194; A204; A210).

Thus, under the applicable regulatory scheme, the notes held by Exchange National Bank, along with other similar subordinated notes, were reported to the S.E.C., the stock exchanges and the public on Weis' financial statements as representing investments in Weis' capital structure, and not as commercial loans. As explained in the affidavit of Harvey J. Bazaar, a Certified Public Accountant expert in the area of stockbrokerage auditing, the reason for that accounting treatment is that such subordinated obligations traditionally have characteristics so analogous to stockholders' equity that they must be posted in a similar manner (A192-199). Since the claims of subordinated lenders, like the claims of stockholders, must await full satisfaction of the claims of general creditors, the two types of capital are treated similarly in statements intended for use by the public (A194-A195).

ARGUMENT

POINT I

IN THE "FINANCIAL CONTEXT" PRESENTED HERE, THE SUBORDINATED NOTES OF A BROKER-DEALER ARE SECURITIES

Touche's contention that the notes purchased by plaintiff are not "securities" is based entirely on its conclusory statement, constantly repeated in its brief, that the transaction giving rise to the notes was "a typical commercial loan transaction" and not an "investment." But that assumes the very issue which is before this Court and which Judge Wyatt resolved by finding that the transaction was "more in the character of an investment than of a commercial loan" (A223). Judge Wyatt's holding should be affirmed because, in the "financial context" presented by the record, it was clearly correct.

In considering the 'financial context,' this Court will no doubt bear in mind the federal courts' long-standing policy of construing federal securities legislation "not technically and restrictively, but flexibly to effectuate its remedial purposes." S.E.C. v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 195 (1963); see, United Housing Foundation, Inc. v. Forman, 421 U.S. 837, 847-850 (1975); Tcherepnin v. Knight,

389 U.S. 332 (1967); S.E.C. v. W. J. Howey Co., 328 U.S. 293 (1946); C.N.S. Enterprises, Inc. v. G. & G. Enterprises, Inc., 408 F.2d 1354 (2d Cir. 1975), cert. denied, 44 U.S.L.W. 3201 (1975); Movielab, Inc. v. Berkey Photo, Inc., 452 F.2d 662, 663-664 (2d Cir. 1971).

As the Supreme Court recently recognized, Congress intended the application of the securities laws to "turn on the economic realities underlying a transaction," United Housing Foundation, Inc. v. Forman, supra, 421 U.S. at 849, 851. Thus, Congress "sought to define 'the term "security'" in sufficiently broad and general terms so as to include within that definition the many types of instruments that in our commercial world fall within the ordinary concept of a security.'" Id. at 847-848, quoting H.R. Rep. No. 85, 73d Cong., 1st Sess., 11 (1933). As the courts have said time and again, the determination of what is a "security" should embody flexible rather than static ideas, which are capable of keeping pace with the various schemes devised by those who seek the application of others' property in return for the promise of profit. See, S.E.C. v. W.J. Howey Co., supra, 328 U.S. at 299. Thus it is that the emphasis is properly placed on the "economic realities" of the transaction, and not its surface form. Tcherepnin v. Knight, supra, 389 U.S. at 336; Hughes v. Dempsey-Tegeler & Co., Inc., CCH Fed. Sec. L. Rep.

¶ 94,133 at 94,538 (C.D. Cal. 1973).

Touche, in its brief, pays lip service to the principle of focusing on the "economic realities" of the transaction. It thus devotes ten pages to arguing that the courts must look to the "financial context" of a transaction in which an instrument was issued in order to determine whether or not it is a security (Brief, pp. 17-27) and that a usual commercial loan note is not a security -- both propositions which are not in dispute.* However, after stressing the uncontested principle that the "financial context" and "economic realities" are of critical importance, Touche ignores or makes light of those factors and instead relies almost exclusively on the face of the notes and its own self-serving assumption that the transaction was a "routine commercial loan." But when the full financial context is examined, as it was by Judge Wyatt, the conclusion is inescapable that plaintiff's commitment of funds to Weis was no run-of-the-mill commercial loan, but possessed the hallmarks of investment transactions which have traditionally led to application of the federal securities laws.

* To the extent the cases cited by Touche (Brief, pp. 20-26) stand for those propositions, we do not dispute Touche's reading of them. However, as we shall show infra, pp. 37-44, Touche's attempt to fit the facts of this case into the rationale of those cases is not supported by the cases themselves.

1. The Subordination Feature

We begin with the fact that Weis, in order to raise additional net capital for the general expansion of its brokerage activities around the world, went to many different financial institutions offering an investment opportunity which, if accepted, would subordinate the interest of those investors to the claims of all of its general creditors. Because Weis had reached the limits of unsubordinated indebtedness permitted under New York Stock Exchange Rule 325, it was required to seek additional capital from investors who were willing to stand behind the claims of its general creditors and -- most significantly for a brokerage firm -- of its thousands of retail trading customers. Thus, the Weis notes held by Exchange National Bank (in common with the Weis notes held by several other financial institutions) contained subordination provisions. Paragraph 2 of the notes held by Exchange National Bank provided (see, e.g., A91):

"The rights of the holder hereof to, and payment of the principal sum or any part thereof, and the interest due thereon, are and shall be subject and subordinate in right of payment to and subject to the prior payment or provision for payment in full of all claims of present and future creditors of the Company ('General Creditors') arising out of any matter occurring prior to the Maturity Date."

Due to the subordination feature, the ability of plaintiff and similar noteholders to recover their initial

investments and receive a profit depended directly upon the ability of Weis to earn sufficient income to satisfy in full the claims of its general creditors. The subordination feature thus brings the present transaction squarely within the rationale enunciated by the Supreme Court last term in United Housing Foundation, Inc. v. Forman, supra, 421 U.S. 837 (1975). There, the Supreme Court held that "the basic test" for distinguishing security transactions from "other commercial dealings" is "whether the scheme involves an investment of money in a common enterprise with profits to come solely from the efforts of others." This test, the Court added,

"embodies the essential attributes that run through all of the Court's decisions defining a security. The touchstone is the presence of an investment in a common venture, premised on a reasonable expectation of profits to be derived from the entrepreneurial or managerial efforts of others. By profits, the Court has meant either capital appreciation . . . or a participation in earnings resulting from the use of investors' funds." 421 U.S. at 852.

The Court reasoned, based on S.E.C. v. W.J. Howey Co., supra, 328 U.S. at 300, that in the case of a security, "the investor is attracted solely by the prospects of a return on his investment," whereas, by contrast, "when a purchaser is motivated by a desire to use or consume the item purchased . . . the securities laws do not apply." 421 U.S. at 852-853.

The subordinated notes involved here squarely meet the test of "an investment of money in a common enterprise with profits to come solely from the efforts of others." Because both repayment of the initial investment and the payment of interest on the notes were subordinated to all general obligations of Weis, plaintiff took an investor's, not a lender's risk, and committed its funds based upon its "reasonable expectation of profits to be derived from the entrepreneurial or managerial efforts of" Weis' management. Certainly, Exchange National Bank had no desire, or even opportunity, to "use or consume" the notes.

Adopting identical reasoning to that employed by the Supreme Court in Forman, several federal courts have held transactions involving subordinated obligations of broker-dealers to be covered by the federal securities laws. See, New York Stock Exchange, Inc. v. Sloan, 394 F. Supp. 1303 (S.D.N.Y. 1975); Hughes v. Dempsey-Tegeler & Co., Inc., supra, CCH Fed. Sec. L. Rep. ¶ 94,133 (C.D. Cal. 1973) at p. 94,538; Fischer v. New York Stock Exchange, F. Supp. (S.D.N.Y., 75 Civ. 1630, January 15, 1976).

In New York Stock Exchange, Inc. v. Sloan, supra, Judge Lasker squarely held that a subordinated obligation of a brokerage firm was a security. In Sloan, the New York Stock

Exchange sued, among others, subordinated lenders of Orvis Brothers & Co., -- a member firm in liquidation -- to recapture expenditures paid by the Exchange from its Special Trust Fund to public customers of Orvis. Sixteen of the defendants counterclaimed against the Exchange for the loss of their investments in Orvis, claiming that the Exchange failed to perform its statutory duty to enforce its own rules.

The Exchange moved to dismiss the counterclaim on the ground that the subordinated lenders had not purchased "securities," but Judge Lasker determined that subordinated lenders to a broker-dealer are "investors" who hold "securities" within the meaning of the securities laws (394 F. Supp. at 1311):

"The definition of a security as set forth in § 2(1) of the Securities Act of 1933 (15 U.S.C. § 77(b)(1)) and § 3(a)(10) of the Exchange Act of 1934 (15 U.S.C. § 78c(a)(10)) includes 'any . . . investment contract.' The Supreme Court has defined such contracts as any 'contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of a promoter of a third party.' SEC v. W.J. Howey Co., 328 U.S. 203, 298-299 (1947). A subordination agreement meets this test because it subjects the securities of the lender to the claims of creditors in exchange for the payment of interest by the borrower; and the continuing payment of interest to him depends wholly on the efforts of the borrower, in this case, Orvis."

"Moreover, because a subordination agreement establishes the borrower's obligation to pay interest for the use of securities, it is also an 'evidence of indebtedness' under §§ 2(1) and 3(a)(10). See United States v. Jones, 450 F.2d 523, 525 (5th Cir. 1971) Farrell v. United States, 321 F.2d 409, 417 (9th Cir. 1962), cert. denied, 375 U.S. 992 (1964)." (emphasis added)

The subordination clause in the notes in this case, just as in Sloan, make plaintiff's investment "subject . . . to the claims of creditors in exchange for the payment of interest by the borrower," and "the continuing payment of interest to [the Bank] depends wholly on the efforts of the borrower." In addition, of course, the notes are manifestly "evidence of indebtedness." Plaintiff's notes are, therefore, just as the interests in Sloan, "securities" for purposes of the securities laws.

In Sloan, Judge Lasker cited and followed the earlier decision in Hughes v. Dempsey-Tegeler & Co., Inc., supra, CCH ¶ 94,133 (C.D. Cal. 1973). In that case, plaintiff had agreed to subordinate a substantial portion of his securities portfolio to Dempsey-Tegeler & Co., Inc., a brokerage firm with which he had enjoyed mutually beneficial business dealings in the past and with whose officers he had developed a relationship of friendship and trust. In order to help rescue the brokerage firm from financial troubles, the agreement permitted use of Hughes' personal portfolio as additional capital of the firm to meet the New York Stock Exchange's net capital requirements.

The Court in Hughes answered affirmatively the question of "whether the inherent nature of Hughes' subordination entitles it to protection under the two Federal securities

statutes" (Id. at 94,537). Noting that Hughes' subordination agreement would "subject his securities to the claims of actual and potential creditors" in exchange for anticipated profits in the form of interest, the Court found that "the economic realities of the transaction" dictated that the subordination agreement was a security. The Court wrote (Id. at 94,538):

"The facts clearly indicate that Hughes contemplated acquisition of profits from his investment of securities, pursuant to the subordination agreement, which investment was controlled solely by the efforts of those who promoted the idea to him. Therefore, the subordination agreement was an 'investment contract' under the Securities Act, and is entitled to protection as a 'security.' Inasmuch as the subordination agreement does not fall within the short-term commercial paper exemption provided for in Section 3(a) (10), it is to be considered an 'investment contract' under the Securities Exchange Act, and is also entitled to protection as a 'security' under that statute. See Sanders v. John Nuveen & Co., Inc., 463 F.2d 1075, 1078-1079 (7th Cir., 1972). Furthermore, inasmuch as the subordination agreement, on its face, establishes an obligation to pay an amount of money earned as interest for the use and application of securities, it is deemed to be an 'evidence of indebtedness' within sections 2(1) and 3(a)(10). See United States v. Jones, 450 F.2d 523, 525 (5th Cir., 1971); Farrell v. United States, 321 F.2d 409, 417 (9th Cir., 1963); cert. denied, 375 U.S. 992 (1964)."

Most recently, in Fischer v. New York Stock Exchange, supra, F. Supp. (S.D.N.Y., 75 Civ. 1630, January 15, 1976), four subordinated lenders of Pickard & Company, another defunct

brokerage firm, sued the New York Stock Exchange and Pickard's receiver for violating Rule 10b-5. The Exchange moved to dismiss on the ground that the retention by plaintiffs of Pickard's subordinated obligations over a prolonged period of time -- during which they executed several extension agreements -- did not constitute the purchase or sale of securities. In rejecting that contention, the Court implicitly recognized that the subordinated obligations of a broker-dealer were "securities" within the meaning of the federal securities laws:

"Upon the termination date [of the subordinated loan agreement], Pickard would have been obliged to repay the loans. Each agreement to extend the arrangement therefore represented a new decision by the [subordinated] lenders to invest in Pickard and for purposes of Rule 10b-5, each extension agreement is entitled to be treated as a sale and purchase of a security."

Touche has attempted to distinguish the rationale of these cases on several grounds. First, it claims that Sloan is not controlling here because in that case, the subordinated lenders had lent securities rather than cash to a broker-dealer (Brief, p. 40). But that factor played absolutely no part in Judge Lasker's reasoning in Sloan. Judge Lasker determined that a subordination agreement met the test of a security because (1) the assets of the lender were "subjected to claims of creditors" in exchange for the payment of interest to the borrower and (2) the payment of

interest depended entirely on the efforts of the borrower. Nowhere in the Sloan opinion did Judge Lasker suggest that the loan of securities, rather than the fact of subordination itself, was the controlling factor. His reasoning applies with equal force to a subordinated loan of any kind of assets, whether they be securities or cash or any other thing of value. Indeed, Judge Lasker referred to the Exchange Rules enacted under § 6 of the 1934 Act as protecting "those who entrust their funds or securities to broker-dealers" (394 F. Supp. at 1310; emphasis supplied).

The lack of merit in Touche's purported distinction of Sloan is seen clearly from the facts and rationale in Hughes. The "economic realities" of the transaction in Hughes would not have been changed in any material respect had Hughes contributed cash to shore up the net capital of Dempsey-Tegeler, in return for subordinated notes, rather than agreeing to the subordination of his existing securities portfolio with the firm. In either case, there is the same motivation and expectation of profits, and the same dependence on the managerial efforts of the firm, which led the Court to characterize the subordination agreement as a "security." Thus, here too, there is no material difference, as a matter of "economic reality," between Exchange National Bank's commitment of cash to Weis and other subordinated lenders' commitment of securities.

Touche also attempts to distinguish Sloan on the ground that the subordinated lender in this case is a commercial bank. But there is no support for the proposition that the character of an instrument is dependent upon the identity of the holder. Such a proposition would mean that identical notes, if sold to individual investors, would be "securities," and this Court would have jurisdiction over the identical claim asserted by them. Surely neither logic nor the purpose of the federal securities laws compels such a result.

2. Exchange Rule 325

The subordination feature of the Weis notes was, of course, in conformity with the requirements of New York Stock Exchange Rule 325.* The structure and purpose of that Rule serve to demonstrate the soundness of the rationale adopted in Sloan and Hughes.

Rule 325 provides that the obligations of broker-dealers which are subordinated to general creditors pursuant to subordination agreements approved by the Exchange are specifically excluded from "aggregate indebtedness" and are to be included instead in the computation of "net capital"

* Rule 325 is set forth in full in Appendix A to this Brief.

in meeting the requirements of the Rule. To begin with, the language of the Rule makes no distinction between subordination agreements involving securities and those involving cash, thus further undermining Touche's attempt to distinguish Sloan on that basis. More important, as the Bazaar affidavit demonstrates (Al93), Rule 325 is premised on the same understanding enunciated in Sloan and Hughes: that the interests of subordinated lenders, like the interests of stockholders, can be satisfied only after all claims of general creditors are fully satisfied and are therefore much more like the interests of equity stockholders than of commercial creditors. Thus it is that Rule 325 requires broker-dealers, in financial statements intended for public scrutiny, to treat subordinated obligations similarly with equity, under "net capital," and not in the same fashion as unsubordinated commercial indebtedness.

The way in which an issuer treats an instrument on its own financial statements is, of course, one of the recognized indicia of whether such an instrument is a security. See, C.N.S. Enterprises, Inc. v. G.&G. Enterprises, Inc., 508 F.2d 1354, 1361 (7th Cir. 1975), cert. denied, 44 U.S.L.W. 3201 (1975); Sanders v. John Nuveen & Co., Inc., 463 F.2d 1075, 1079 (7th Cir. 1972), cert. denied, 409 U.S. 1009 (1972). Here, because of the subordination feature, the notes were never treated by Weis as commercial loan obligations. Rather, as required by Rule 325, the subordinated notes were

listed on Weis' balance sheets and financial statements under the heading entitled "Subordinated liabilities and stockholders' equity," while normal commercial loans were listed under "aggregate indebtedness" (A130-A132; A192-A199). That is an accounting treatment which Touche, as Weis' auditors, necessarily approved (indeed, had to make sure was followed) with respect to the subordinated notes, similar to plaintiff's, issued to at least two financial institutions prior to May 26, 1972 (see, pp. 10-11, supra; A204; A210). It is odd indeed for Touche to have said, in certifying the May 26, 1972 financials, that such notes were properly treated as "net capital" of Weis, and now to argue to this Court that they are not "securities."

Touche attempts to avoid the implications of the accounting treatment mandated by Rule 325 by arguing that "net capital" is nothing more than a "term of art." (Brief, p. 44.) But Rule 325 was clearly not designed for artificial purposes: its requirement that subordinated obligations be excluded from "aggregate indebtedness" and included in "net capital" is at the heart of the Rule's purpose of regulating the financial structure of broker-dealers by insuring that aggregate unsubordinated indebtedness may not exceed 1500% of net capital. As Mr. Bazaar stated, "net capital is viewed by the S.E.C. and the Exchange as a fund of liquid assets available to pay claims of customers and creditors of a broker-dealer" (A193). See also,

Hughes v. Dempsey-Tegeler & Co., Inc., supra, CCH Fed. Sec. L. Rep. at p. 94,527, n. 2.

Weis, of course, was fully mindful of the debt/capital ratio imposed by Rule 325 when it proposed the transaction to the Bank. It was not interested in adding to its aggregate indebtedness by an unsubordinated commercial loan. Rather, it was seeking to obtain funds for inclusion in its net capital under the Rule, thereby enabling it to increase proportionately the amount of aggregate indebtedness it could incur from other sources (A53-A54). The last thing Weis wanted from Exchange National Bank was an ordinary commercial loan.

Finally, Touche's reliance on the suggested headings for balance sheets in ¶ 2325.30 of the New York Stock Exchange Guide (Brief, p. 45) ignores the crucial fact here -- that, whatever the Guide permits, Weis did list subordinated notes under the joint heading "Subordinated liabilities and stockholders' equity" on its own financial statements (A204; A210).

3. Exchange National Bank's Expectation of Future Business with Weis

In Hughes v. Dempsey-Tegeler & Co., Inc., supra, the Court took great pains to detail over several pages the history of mutually beneficial business relationships between Hughes and his company, on the one hand, and the brokerage firm on

the other. It noted not only past business dealings between the two, but also the personal relationships of trust and friendship between Hughes and two principals of Dempsey-Tegeler & Co., Inc. It was based upon this lengthy recital of the facts that the court concluded that Hughes' contemplated acquisition of profits from his investments in Dempsey-Tegeler indicated that his subordination agreement was a "security."

Here, too, Exchange National Bank's expectation of profits was based not only on the receipt of interest, but also, as set forth in the affidavit of Mr. Lippe, upon the anticipation that the Bank's investment in Weis would "spur a closer relationship between the two organizations" which would "lead to continuous cooperation and expansion to the mutual benefit of both companies, especially in regard to Israeli-based operations" (A53).

Touche merely responds by offering its own view that the Bank's motivation was "nothing more than the ordinary expectation of a commercial bank that its loan customers would also use it as a depository for funds" (Brief, p. 45). That is a gross distortion of the record as to the Bank's purpose in entering into the transaction. As set forth at length in the Lippe affidavit (A52-A54), among the Bank's reasons to invest funds in Weis was the hope not only that Weis itself would use the Bank's services

but that, by reason of the Bank's investment, Weis' management would encourage Weis' customers in Israel and elsewhere to clear their funds through Exchange National Bank. And even that was only one aspect of the hoped-for "mutual benefit." In sum, the Bank was not merely lending money in hope of receiving it back with interest when it became due. Rather, it was investing in the future prospects of a mutually beneficial expansion of its own business and that of Weis.

It is entirely consistent with these broader business motivations that the transaction giving rise to the notes was handled entirely outside of the Bank's normal commercial loan channels. Mr. Lippe, the Exchange National Bank officer who conducted the negotiations, was an Executive Vice President with responsibilities over the Bank's expansion and investments, not a commercial loan officer. His duties did not involve negotiating or handling commercial loans (A51-A52).

Perhaps the most significant fact about the manner in which the transaction was handled by the parties is that the notes were neither drafted by the Bank, nor did they bear any resemblance to the usual form utilized by Exchange National Bank for its commercial borrowers. The form was, in fact, brought to the Bank by the Weis officers, and was based on a form prescribed for member firms by the Exchange (A53-A54). Thus, even with respect to the drafting of the instrument, the "financial context" resembles the purchase of a security where, typically, the issuer, not the holder, has

prepared the form of the instrument. In Exchange National Bank's normal commercial loan dealings, the form of the loan note is always prepared by the Bank, not the borrower (A53-A54).*

4. Similar Securities Were Offered to Other Potential Investors

Another crucial element in determining the "financial context" is to evaluate how many similar subordinated obligations have been offered or issued to other investors. The greater the number, the more obvious the "investment" nature of the transaction. Sanders v. John Nuveen & Co., Inc., supra, 463 F.2d at 1079 S.E.C. v. Addison, 184 F. Supp. 709 (N.D. Tex. 1961); Prentice v. Hsu, 280 F. Supp. 384 (S.D.N.Y. 1968); S.E.C. v. Thunderbird Valley, Inc., 356 F. Supp. 184 (D.S.D. 1973).

When it acquired the Weis notes, the Bank knew (A54) that there were at least three similar Weis notes outstanding in the hands of other investors. Those three notes (A60-A89)

* Touche argues (Brief, pp. 28-29) that the transaction is really a commercial loan because Mr. Lippe stated only that he did not handle "normal commercial loans," but did not specifically deny the inference that the Bank makes commercial loans which are "not in its 'normal' pattern." That argument is the height of sophistry. The Lippe affidavit clearly states that the Bank has a staff which handles commercial loans, that Mr. Lippe is not a member of that staff, and that Mr. Lippe handled this transaction which gave rise to instruments differing substantially from the Bank's normal loan note (A51-A59). The emphasis on the word "normal" was, of course, as an antidote to Touche's constant reiteration of the assumption that this was an "ordinary commercial loan."

each exhibit the same major characteristics as the Exchange National Bank's notes -- subordination to general creditors, limited transferability, the right to defend legal actions, and limited prepayment rights subject to New York Stock Exchange approval.

After its investment in Weis, the Bank learned of several more substantially similar subordinated notes issued to still other investors.* Indeed, Weis' SIPC trustee has indicated that there are subordinated obligations to at least 50 other subordinated lenders to Weis in addition to plaintiff (A158-A191).

Thus, taken in context, it appears that the notes held by Exchange National Bank do not constitute an isolated "borrowing" of money by Weis, but were part of a broad ranging effort by Weis to raise capital for expanded operations by making many similar subordinated arrangements with many different investors. We submit that this demonstrates -- indeed, would establish were it not otherwise established -- that these subordinated obligations, including the notes sold to the plaintiff, were securities under the federal securities laws.

* And, of course, there is no way of knowing how many such investments were offered to additional offerees who declined the opportunity to purchase.

Touche, in response, merely suggests that, because the subordination provision of each note held by the Bank makes those notes senior to some other subordinated obligations, and pari passu with \$3,000,000 of other subordinated notes, Weis could not have offered notes with "the very same provisions" as those held by the Bank "widely to a substantial number of persons" (Brief, p. 42) -- although that is what Weis told Lippe it intended to do (A54). That argument, however, misses the point. We are not arguing that Weis made an unregistered public offering of securities (although it may have). We are demonstrating that what it offered to plaintiff and others and what the plaintiff was sold, were in fact securities.

Moreover, it matters not whether exactly the same obligations were offered to others, or that some subordinated obligations were subordinated to other subordinated obligations. It is clear that over fifty investors committed millions of dollars to Weis in return for subordinated obligations (A160; A172-A182). Each of them -- by virtue of the subordination feature -- was dependent upon the success of Weis for a return on, and the return of, the investment and thus, under the rationale of Forman, Hughes and Sloan, held a "security" for federal jurisdictional purposes.

POINT II

THE NOTES THEMSELVES INDICATE THEY ARE SECURITIES

As noted, Touche dwells almost exclusively upon the terms of the notes themselves, ignoring or distorting the economic realities of the transaction. But even in so doing, it overlooks or mischaracterizes provisions of the notes which clearly are not attributes of a "typical commercial loan," but, on the contrary, indicate the investment nature of the transaction. Those terms, which, as noted, were drafted by Weis, not the bank, include

- (1) the subordination clause, (2) limited transferability,
- (3) a restriction on prepayment by Weis tied to a sale of securities by it, (4) the ability of the noteholder to defend actions against Weis, and (5) the requirement of six-months' notice prior to maturity of the note.

1. The Subordination Clause

The effect of the subordination feature on the "financial context" has been fully discussed. But it should be noted here that the subordination clause, found in paragraph 2 of each note, is not part of the usual loan note executed by commercial borrowers from Exchange National Bank (A54-A55; A117) or, indeed, from other banks. Rather, it clearly reflects the investment characteristics of the notes.

2. The Restrictions on Transferability

The Weis notes have limited transferability: before the holder can transfer the notes, it must receive the approval of the New York Stock Exchange (Notes, ¶ 12; see, e.g., A97). Change National Bank's normal loan note (A117), of course, had no such provision. Such a limitation is not at all characteristic of the "typical commercial loan" which Touche assumes this transaction to have been.

Touche, quoting a phrase from United Housing Foundation, Inc. v. Forman, supra, 421 U.S. at 851 (Brief, p. 44), suggests that the restrictions on transferability support its own position. But the Forman quote indicates simply that a share in a housing cooperative which could not be transferred to a non-tenant and descended only to a surviving spouse, was not a security. The Supreme Court did not hold, as Touche implies, that limits on transferability preclude denomination as a security. Were that the case, numerous kinds of instruments, such as "letter stock" for example, would lose the protections of the federal securities laws. Such restrictions, of course, do not of themselves make the Weis notes securities, but they certainly do show that the transaction was not a usual commercial loan as Touche contends.

3. The Prepayment Provision

Paragraph 3(a)(i) of each note requires that Weis can prepay the note only with the approval of the Exchange --

another provision not found in a typical commercial loan note (see, e.g., A92). Further more, under paragraph 3(a)(ii), Weis agrees that if it determines to sell "any of its securities" it will, if the Exchange approves, "apply the net cash proceeds" of any such sale to the prepayment of the notes (A92). This provision, like the subordination clause and the transferability restriction, is found nowhere in the Bank's own form of commercial loan note (A117).

4. The Noteholder's Ability to Defend Actions Against Weis

Touche contends that the notes do not give Exchange National Bank "any control over or participation in the operations and affairs of Weis, under any circumstances" (Brief, p. 36) (a contention which, even if true, would not deprive these subordinated obligations of their character as "securities"). Contrary to that contention, the notes do indeed grant the holder the ability to participate in Weis' affairs. Specifically, Paragraph 5 of each note grants the holder the right to defend "any legal action" which is brought against Weis "by a General Creditor" within one year after the maturity date of the note, if Weis has decided not to contest the lawsuit. Not only is the holder given the right to defend the suit, but it can do so in either its own name or in Weis' name, and "by counsel of its own choosing at [Weis'] expense" (see, e.g. A95). These

are clearly rights which are normally accorded only to someone with an investment interest in the issuer of securities and not to a routine commercial lender.

5. The Maturity Date

The first paragraph of each note (see, e.g., A90) contains a highly unusual provision with respect to the maturity date of each note. It provides that the note shall become due only "upon written demand received by [Weis] at least six (6) months prior to" the desired maturity date. This provision, like all of those listed above, is foreign to the kind of note which would be issued in a typical commercial loan transaction, and is, of course, not found in Exchange National Bank's commercial loan note (All7).

* * *

In sum, even ignoring for the moment the "financial context," as Touche does, and looking only to the face of the notes themselves, there are so many provisions revealing the "investment" character of the transaction, which are not found in the usual loan note of commercial banks, that the notes must clearly be held to be "securities."

POINT III

THE AUTHORITIES RELIED UPON BY
TOUCHE DO NOT SUPPORT REVERSAL

Touche relies in its memorandum primarily upon four cases, each of which held that the particular instrument in question was not a security. As already noted, those cases stand primarily for the propositions -- undisputed here -- that the "financial context" governs and that a routine unsubordinated bank loan to a commercial borrower is not a securities transaction. But, in each of those cases, the instruments and the financial context giving rise to those instruments exhibited important commercial characteristics which distinguish them from the situation in this case.

For example, Touche cites Bellah v. First National Bank of Hereford, Texas, 495 F.2d 1109 (5th Cir. 1974), in which the Fifth Circuit specifically stated that "we merely hold that notes issued in the context of a commercial loan transaction fall beyond the purview of the [Securities Exchange] Act" (495 F.2d at 1114). The transaction in Bellah was the most typical kind of routine commercial loan imaginable: the notes were of only 6 months duration, the purpose was to renew a pre-existing loan to a family livestock business, the transaction involved only a single borrower and its bank, and the record was, in the court's terms, "bereft of any evidence

indicating that the Bank sought to profit from the successful operation of this enterprise" (495 F.2d at 1113). In contrast, of course, in this case, a principal purpose of the investment was to promote future business relationships between the Bank and Weis, not to renew an existing bank loan; the notes have minimum durations of one year, 15 months, and 18 months and can be extended by the Bank; subordinated obligations with similar provisions were offered to a large group of potential investors; and, because of the subordination provision, the Bank necessarily looked for its profit to "the successful operation" of the Weis enterprise.

Touche also relies heavily upon McClure v. First National Bank of Lubbock, Texas, 497 F.2d 490 (5th Cir. 1974), cert. denied, 420 U.S. 930 (1975), in which a one-year promissory note given for a bank loan was held to be reflective of a "commercial" transaction and hence "outside the purview of the [Securities Exchange] Act", 497 F.2d at 493. There, as in Bellah, the transaction involved was merely the renewal of a routine bank loan to a local family-owned business -- a far cry from the transaction presented here. Moreover, the language from McClure quoted by Touche (Brief, p. 22) actually shows why the notes in this case are securities. The Fifth Circuit wrote (497 F.2d at 493):

". . . where notes have been deemed securities within the meaning of the securities laws either of two factors, not present here, usually indicated the investment overtones or the underlying transactions. First . . . [the] notes were neither offered to some class of investors, nor were they acquired by the Bank, for speculation or investment

Second, in the case at bar, the Bank ostensibly extended its loan so that [the borrower] might pay off its business debt. Thus [the borrower] did not obtain investment assets, directly or indirectly, in exchange for its notes."

In this case, of course, both of those factors which "indicated the investment overtones of the underlying transactions" are present. As set forth in the affidavits submitted below, similar obligations were offered to other potential investors, and the Bank acquired them for investment purposes, not only for profit directly thereon but also in an effort to increase the reciprocal business arrangements of the Bank and Weis both here and abroad. Moreover, since Weis' basic business as a broker-dealer consisted of dealing in securities and other "investment assets," and the proceeds of the transaction were to be used by Weis for general expansion of that business (not, as in McClure, to pay off business debts) Weis did, in a very real sense, "obtain investment assets . . . in exchange for its notes."

Finally, in Thorp Commercial Corp. v. Northgate Industries, Inc., CCH Fed. Sec. L. Rep. ¶ 94,929 (D. Minn., 1974), after properly observing that "the commercial or investment character of promissory notes can be determined only from examination of the total transaction," (Id. at p. 97,212), the Court looked at two "critical elements of investment notes," namely, "the payee-lendor's expectations of participating in the profits of the maker or of receiving substantial benefits from the maker's success extrinsic to the direct return on the loan" and whether "the maker offers its notes to investors."

The Court went on to find that neither of those elements was found in the transaction at issue. But, as pointed out above, both of those elements are present here. Exchange National Bank hoped to participate in the profits of Weis through its subordination to the general creditors and through the hope of increased business for Weis in Israel and elsewhere, and similar Weis obligations were offered to other investors.

Touche also suggests (Brief, pp. 37-38) that the notes are not securities because they do not meet the Uniform Commercial Code's definition of a security. However, Touche cites not a single case nor commentator which suggests that the definition of a security under the federal securities

law is dependent in the slightest upon the U.C.C. definition. Indeed, the Official Comment to the U.C.C., which Touche cites only selectively, specifically contrasts the U.C.C. definition of a security with the definition in the federal statutes. There are certain instruments, the Comment notes, which are not covered by the U.C.C. definition of a security even though they may be securities "under regulatory statutes like the Securities Act of 1933." 62-1/2 McKinney's, Uniform Commercial Code § 8-102, Official Comment, p. 163. Thus, by the recognition of the framers of the U.C.C. themselves, Touche's U.C.C. analogy gets it nowhere.

* * *

There is no better summary of the factors supporting Judge Wyatt's decision below than the one appearing in C.N.S. Enterprises, Inc. v. G. & G. Enterprises, Inc., supra, 508 F.2d 1354 (7th Cir. 1975), a case relied upon by Touche. In that case, which also involved a routine commercial loan (to a local laundry and dry cleaning business in Justice, Illinois), the Seventh Circuit cited with approval a "long list of possible criteria" for distinguishing ordinary commercial notes from securities, which had appeared in a law review comment. The Seventh Circuit wrote (508 F.2d at 1361):

"A comprehensive and perceptive student comment suggests a long list of possible criteria to distinguish ordinary commercial notes not protected by the act from investment notes or investment securities protected by the act: (1) how is the instrument characterized in the business community? (2) how are the proceeds to be used (if for consumer goods or particular business goods or services -- not covered, but if for general financing of borrower's enterprise -- covered)? (3) extent of reliance on efforts of others (placing funds at great risk, giving note payee extensive collateral rights, making repayment of funds contingent upon some event, all tend to indicate security rather than loan); (4) number of notes issued, number of payees, dollar amount of transaction; (5) payable on demand or if payable at fixed time, how long is the time between issuance and maturity? and (6) characterization of notes on relevant financial statements. Comment, Commercial Notes and Definition of 'Security' Under Securities Exchange Act of 1934: A Note Is a Note Is a Note?" 52 Neb. L. Rev. 478, 510-24 (1973).*

Each one of these six tests, when applied in this case, indicates that the Weis notes are securities:

(1) The instruments have been "characterized in the business community" -- in this case, both the New York Stock Exchange through Rule 325 and Weis itself in its financial statements -- as part of "net capital" rather than as merely evidence of indebtedness.

(2) The proceeds were to be used for the general financing and expansion of Weis' securities enterprise, not

* The same Comment was also cited with approval by the Fifth Circuit in McClure, supra, 497 F.2d at 493, n. 2.

for "consumer goods or particular business goods or services."

(3) The subordination feature made repayment of principal and interest "contingent" upon the success of the "efforts of others."

(4) Other similar obligations were issued by Weis, and the aggregate of the subordinated obligations amounted to many millions of dollars.

(5) The notes were not "payable on demand" and "the time between issuance and maturity" was a minimum of 12, 15 and 18 months, respectively, and could then be made payable only upon six months written demand by the Bank.

(6) The "characterization of the notes on relevant financial statements" was to list them under the joint heading "Subordinated liabilities and stockholders' equity," as part of Weis' capital structure, not as part of its indebtedness.

In sum, the economic realities of the transaction, as catalogued in the list approved in C.N.S., all indicate that the notes are, as Judge Wyatt held, "securities" for purposes of the federal securities laws.

CONCLUSION

For the foregoing reasons, Judge Wyatt's order denying Touche's motion to dismiss for lack of subject matter jurisdiction should be affirmed, with costs.

Respectfully submitted,

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February 23, 1976

Operation of Member Organizations

Capital Requirements

*(Rules and Policies Administered by
Regulation & Surveillance.)*

¶ 2325 Capital Requirements for Member Organizations and Individual Members

General provisions

Rule 325. (a) No member or member organization doing any business with others than members or member organizations or doing a general business with the public, except a member or member organization subject to supervision by State or Federal banking authorities, shall permit, in the ordinary course of business as a broker, his or its Aggregate Indebtedness to exceed 1500 per centum of his or its Net Capital, which Net Capital shall be not less than \$100,000 in the case of a member organization which carries any accounts for customers, which services customer accounts from more than one office, which effects principal transactions or which has a corporate affiliate or corporate subsidiary, not less than \$50,000 in the case of any other member organization subject to this rule, not less than \$50,000 for any member who services customer accounts and employs a registered representative, and not less than \$25,000 in the case of any member who services customer accounts, unless a specific temporary exception is made by the Exchange in the case of a particular member or member organization due to unusual circumstances.

The initial Net Capital of a member organization shall be at least twice the Net Capital required to be maintained by this rule.

The Exchange may at any time or from time to time in the case of a particular member or member organization prescribe greater requirements than those prescribed herein.

Each member or member organization shall forthwith notify the Exchange if his or its Net Capital does not equal or exceed the minimum required by this rule, or if his or its Aggregate Indebtedness exceeds 1200 per centum of his or its Net Capital.

No member corporation shall permit that part of its net worth not attributable to capital stock to exceed 70% of its net worth (75% in the case of member corporations having no freely transferable security outstanding) for a period in excess of 90 days, or for such longer period which the Exchange may upon application of the member corporation grant in the public interest or for the protection of investors. For a member corporation which has outstanding any freely transferable security and which is required to file reports under Section 13 or 15(d) of the Securities Exchange Act of 1934, at least 25% of such corporation's net worth shall be attributable to voting common stock.

Amendment.
August 5, 1974.

Definitions

(b) For the purpose of this rule—

(1) The term "proprietary accounts" shall include capital accounts of sole proprietors, investment and trading accounts and participations in joint accounts;

¶ 2325—Continued

(2) the term "Aggregate Indebtedness" shall include the total money liabilities of the member or member organization in all accounts other than customers' and brokers' accounts for commodity future contracts; plus equities in customers' and brokers' accounts for commodity future contracts; plus the market value of securities borrowed (other than for delivery against customers' sales) for which no equivalent value is paid or credited, exclusive of the following:

(A) money borrowed (adequately collateralized) on securities, spot commodities or other assets owned by the member, member firm or a general partner thereof, or the member corporation, on those assets subordinated to general creditors under an agreement approved by the Exchange under Rule 326.13 and on collateral for secured demand notes contributed for purposes of capital under this Rule or Rule 326.13;

(B) money payable against securities loaned which are owned by the member, member firm or a general partner thereof, or the member corporation, those securities subordinated to general creditors under an agreement approved by the Exchange under Rule 326.13 and those securities collateralizing secured demand notes contributed for purposes of capital under this Rule or Rule 326.13;

(C) money payable against securities failed to receive in connection with transactions for the account of the member, member firm or a general partner thereof, or the member corporation or for accounts subordinated to general creditors under an agreement approved by the Exchange under Rule 326.13 and money payable against securities failed to receive which are to be included within collateral for secured demand notes contributed for purposes of capital under this Rule or Rule 326.13;

(D) money borrowings inadequately collateralized by exempted securities under the Securities Exchange Act of 1934;

(E) liabilities subordinated to general creditors pursuant to a separate agreement approved by the Exchange for purposes of capital under this Rule or Rule 326.13;

(F) equities in customers' commodity accounts segregated under the Commodity Exchange Act;

(G) equities in general partners' commodity accounts and credit balances in other accounts of general partners; and

(H) liabilities on open contractual commitments.

(3) The term "Net Worth" shall be the excess of total assets over total liabilities, after provision for current dividends declared and unpaid by a member corporation (except that credit balances covered by cash subordination agreements approved by the Exchange for purposes of capital under this Rule and accounts recording secured demand notes contributed for purposes of capital under this Rule shall not be considered as liabilities) with securities, spot commodities, commodity future contracts in "proprietary accounts" and all other assets marked to market or fair value. A loss, at market, in an individual contractual commitment shall be deducted in determining Net Worth and a profit shall not be included. (See (c)(10), (11), (12) and (13) "Special Provisions" below.)

(4) the term "Net Capital" shall be Net Worth, less the following:

Debit Items**(A) Amounts included in Net Worth for:**

(i) Memberships, furniture and fixtures, real estate and other fixed assets;

(ii) the value of securities which have no ready market or the sale of which is inhibited by a statutory, regulatory or contractual provision;

For the purpose of this rule securities shall be considered as having no ready market value unless at least one of the following conditions is satisfied:

The security is listed, or entitled to unlisted trading privileges, on a recognized U. S. or Canadian stock exchange.

Bids or offers for the security by three or more market makers (which may include the member or organization whose capital position is being computed) are published regularly in a quotation service recognized by the Exchange.

The securities are redeemable at the option of the holder and are securities which have been issued by an open end investment company registered under the Investment Company Act of 1940.

The member or member organization can demonstrate, in writing to the satisfaction of the Exchange, the existence of a market independent of the member or member organization, in which case the Exchange may establish a capital charge of less than 100% consistent with the facts presented. Such lesser capital charge may be approved only with respect to stated factual circumstances and shall terminate automatically upon material change of circumstances or in any event at the end of one year unless specifically renewed, extended or revised upon application of the member or member organization to the Exchange.

The Exchange, upon application in writing by a member or member organization and after investigation, has determined that (a) a corporation wholly or substantially wholly owned by a member organization or its principals may legally and practically be caused by the member organization to liquidate or otherwise distribute asset values to the member organization within thirty days, and (b) has determined that the shares of such corporation may be considered as having a ready market value not in excess of such shares' pro rata participation in the Excess Net Capital of such corporation (computed as though this Rule 325 were directly applicable to such corporation and after provision for all taxes payable by both the owner and such distributing corporation with respect to such distribution) or such lesser amount as may be legally and practically distributable. No such determination shall be made by the Exchange unless the member organization causes such corporation to be audited annually as of the same date as the required audit of the member organization, nor unless any legal opinion considered in making such determination shall have been issued or reaffirmed by counsel

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acceptable to the Exchange at least as recently as the date of the most recent required audit of the member organization.

Written applications by members or member organizations to the Exchange in connection with this section (l)(4)(A)(ii) of Rule 325 shall be factual and, to the extent practicable, shall identify sources of the facts cited. The member or member organization shall have an affirmative duty to advise the Exchange, forthwith, of any material change of circumstances. No legal opinion shall be acceptable to the Exchange in connection with the allowance of capital value for an affiliated corporation as described above unless such opinion shall set forth the actions necessary to effect the distribution of assets, identify the parties having the power to take such actions, specify the relationship, if any, of such parties to the member or member organization and identify and describe the rights of other parties or classes of parties including but not limited to, customers, general creditors, subordinated lenders, employees, adversaries in litigation and governmental or regulatory agencies who may have the power to delay or prevent such distribution.

(iii) unsecured loans and advances to partners and deficits in partners' accounts including those unsecured (see (c)(10) below);

(iv) deficits in customers' accounts including unsecured accounts and notes receivable (see (c)(9), (10), (11) and (12) below);

(v) prepaid rent, insurance and expenses and unsecured advances to employees and salesmen.

(vi) Debit balance in each customer's spot (cash) commodity account other than the result of a tender made on a futures contract within the past 90 days and evidenced by warehouse receipt(s) issued by a warehouse licensed by a commodity exchange except that this provision shall not apply to purchases by customers of gold or silver bullion which upon payment to the seller is within the member organization's control in good deliverable form and covered by appropriate insurance. (See (c)(11) and (12) below.)

With respect to gold or silver bullion, which upon payment to the seller is within the member organization's control in good deliverable form and covered by appropriate insurance, is purchased by customers under agreements wherein full payment is required and is made within seven business days after the date of purchase, or full payment is required and made within an extended or longer period of time as approved by the Exchange upon application, such purchases may be considered bona fide cash transactions which require no deduction from Net Worth in computing Net Capital. In all other purchases by customers of such gold or silver bullion, which liquidate to an equity, cash required, if any, to provide margin equal to 25% (10% if hedged by futures contracts in the same commodity) of the market value of the gold or silver bullion in each such customer's account in equity shall be deducted from Net Worth.

in computing Net Capital. (See (c)(9), (11) and (12) below. See (b)(4)(A)(iv) above and (b)(4)(B) below for the treatment of customers' accounts which liquidate to a deficit).

If upon payment to the seller, gold or silver bullion purchased by customers and paid for by them is not within the member organization's control in good deliverable form and covered by appropriate insurance, the market value of such gold or silver bullion shall be deducted from Net Worth in computing Net Capital so long as the member organization is accountable therefor. If upon payment to the seller, gold or silver bullion purchased for a proprietary account is not within the member or member organization's control in good deliverable form and covered by appropriate insurance, such gold or silver bullion shall be considered to have no market value for purposes of this Rule. (See (c)(11) and (12) below).

Long Positions "Haircuts"

(B) 30% of the market value of securities and spot commodities long in "proprietary accounts" and in customers' accounts in deficit (10% of the market value of spot commodities if they are hedged) or in the event that a greater or lesser percentage is prescribed for the particular class of security in (c) "Special Provisions" below then that greater or lesser percentage.

Excess Short Positions "Haircuts"

(C) The amount determined on the excess of the market value of short positions of securities over the market value of long positions of securities in "proprietary accounts." The excess of the market value of short positions shall be determined separately for each percentage group set forth in this rule and in (c) "Special Provisions" thereof, except that bonds and stocks shall be considered separately. The amount of this debit item shall be 30% of the excess market value of short positions or in the event that a greater or lesser percentage is indicated in (c) "Special Provisions" below, then that greater or lesser percentage. (See (c)(10) below.)

[The next page is 3529.]

Commodity Futures—Proprietary Accounts

(D) 30% of the market value of all long and all short future commodity contracts (other than those contracts representing spreads and straddles in the same commodity and those contracts offsetting or hedging any spot commodity positions) in "proprietary accounts."

Credit Lines

(E) Total of credit lines granted on open commodity contracts in "trade" accounts, with net long positions or in "trade" accounts with net short positions, whichever is greater, plus any credit lines granted on open commodity contracts in "trade" accounts with no net long or net short position. (In computing the credit line granted in the case of each account, deduct the amount of the equity or the amount of the deficit therein, provided such amount is not in excess of the credit line granted, and the deficit, if any, is comprehended in other "Debit Items.") (See (c)(9) below.)

Commodity Futures—Customers' Accounts

(F)(i) Total amount by which the daily limit fluctuation of all future commodity contracts carried for a customer's account or accounts controlled by a customer exceeds 10% of the Net Worth of the member organization. Contracts in each customer's account representing purchases and sales of a like amount of the same commodity in the same market and in the same crop year may be eliminated. The daily limit fluctuations for future contracts effected in foreign markets is to be considered the same as if such contracts had been effected in a domestic market. (See (c)(11) and (12) below.)

(ii) 1½% of the market values of the greater of either the total long or total short future contracts in each commodity carried for all customers. Contracts in each customer's account representing purchases and sales of a like amount of the same commodity in the same market and in the same crop year may be eliminated. (See (c)(11) and (12) below.)

Cash Margin Deficiency

(G) Cash required to provide proper margin in customers' undermargined accounts in accordance with Rule 431 [§ 2431]. (See (c)(9), (11) and (12) below.)

(H) Cash required to provide margin equal to:

(i) the amount required to restore the original margin required by the pertinent commodity exchange or the clearing house requirement, per contract, whichever is greater, when the original margin has been depleted by 50% on all future commodity contracts in each customer's account. Cash required should be exclusive of liquidating deficits. (See (c)(9), (11) and (12) below.)

(ii) 20% of the market value in each customer's account in equity containing spot commodity positions, evidenced by a warehouse receipt, issued by a warehouse licensed by a commodity exchange, which are the result of future contracts ten-

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dered through an exchange within the past 90 days, but not hedged by future contracts in the same commodity. (See (c)(9), (11) and (12) below.)

(iii) 10% of the market value in each customer's combined account in equity when such account contains spot commodity positions, evidenced by a warehouse receipt issued by a warehouse licensed by a commodity exchange, which are the result of future contracts tendered through an exchange within the past 90 days, and hedged by future contracts in the same commodity. (See (c)(9), (11) and (12) below.)

Fails to Deliver Over 39 Days of Age

(I) 10% of the contract value of all securities in fail to deliver from 40 through 49 calendar days; 20% of the contract value of all securities in fail to deliver from 50 through 59 calendar days; and 30% of the contract value of all securities in fail to deliver for 60 or more calendar days.

Undue Concentrations

(J) A charge for undue concentrations in securities commitments other than commitments in U. S. Government Bonds and Canadian Government Bonds (and certain agencies sponsored by such governments) as defined respectively in paragraph (c)(1)(A) and (c)(1)(C).

(i) An "Undue Concentration" shall be deemed to exist if, and to the extent that, the market value of securities of a single issuer which are "Other Proprietary Positions" as defined under (c) (Special Provisions) and securities collateralizing secured demand notes contributed for purposes of capital under this Rule exceeds 15% of "Tentative Net Capital."

(ii) "Tentative Net Capital" shall be Net Capital computed in accordance with the provisions of this Rule 325 except that, for this purpose only, the debit items referred to in paragraphs (b)(4)(B) (Long Positions "Haircuts"), (c) (Special Provisions) and (b)(4)(C) (Excess Short Positions "Haircuts") with respect to marketable securities and the charge for undue concentrations pursuant to this paragraph (J) shall be disregarded.

(iii) The amount of the (additional) charge for undue concentrations shall be determined by multiplying the amount of the undue concentrations by a percentage equivalent to one-half of the percentage charge ("haircut") applied to "Other Proprietary Positions" of securities of the same class pursuant to paragraph (b)(4)(B) or (c), whichever is applicable to such class of securities. (If the undue concentration involves securities of different classes of the same issuer, the amount shall be computed by first applying positions of lower percentage charge ("haircut") under paragraph (b)(4)(B) or (c).)

(iv) In computing the "Capital Requirements Value" of collateral for a secured demand note contributed for purposes

of capital under this Rule, such value shall (unless otherwise specifically provided in such agreement) be computed disregarding this paragraph (J). Any such collateral securities over and above those necessary to comply with the terms of the applicable agreement shall be disregarded for purposes of paragraph (J)(i) above in such manner as to cause the least charge in computing Net Capital.

(v) The prescription in this section (J) of a specific charge for certain undue concentrations shall not diminish the power of the Exchange to direct a member or member organization to reduce its proprietary position in one or more securities to or below the level at which the undue concentration charge attaches or to cause similar reduction of concentrations in accounts other than proprietary accounts.

Unlocated Short Security Differences

(K) A charge for unlocated short security differences determined in the following manner:

(i) Differences initially detected in the course of an audit required by Rule 417, 100% of the market value of such differences remaining unresolved at the earlier of, (1) the actual filing date of the required report relating to preliminary audit work (see "Regulations Prescribed for Audit Under Authority of Rule 417") or the 45th day following the commencement of such preliminary audit work or, (2) in the event such preliminary audit work is not performed, the actual filing date of the audit or the 45th day following the audit date, and not fully and specifically provided for by accounting liability reserve, such charge to be applied retroactively as of the earlier of the date of commencement of the aforementioned preliminary audit work or the audit date and to be taken into account in all subsequent computations of net capital until ultimately resolved.

(ii) Differences detected other than as in (i) above—100% of the market value of such differences remaining unresolved on and after the 45th day following initial discovery, and not fully and specifically provided for by accounting liability reserve, such charge to be applied in all computations of Net Capital on and after such 45th day until ultimately resolved.

Cash and Stock Dividends Receivable and Coupon and Registered Interest Receivable

(L) A charge for uncollected dividends of cash and securities and other similar distributions and coupon and registered interest receivable determined in the following manner. The amount of the deduction shall be determined by first ascertaining the age of the individual receivable items from the appropriate posting date to the books of account and by then applying the percentages specified in the table below to the cash amounts and market value of securities receivable in the respective age categories:

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| Calendar Period From Posting Date | Percentage Charge |
|--------------------------------------|----------------------|
| 1—30 Days | 0% |
| Over 30 Days | 100% |

The "appropriate posting date" as used above shall mean:

- (a) the payable date for the distribution as announced by the distributing corporation through a recognized dividend information service prior to the fourth business day preceding the record date for determination of the persons entitled to receive such distribution, or
- (b) the payable date for the distribution as actually known to the member organization prior to the fourth business day preceding the record date, or
- (c) the earliest date on or after the payable date at which the member organization can reasonably assemble details of its record date positions of a security which has been the subject of a distribution which either: was not announced through a recognized dividend information service; or, was announced through such a service but only on or after the fourth business day preceding the record date.
- (M) A charge equal to the amount, if any, by which the face amount of a secured demand note contributed for purposes of capital under this Rule exceeds the "Capital Requirements Value" of the collateral pledged with respect thereto.

Other

(N) Any other amounts rightly to be comprehended as "Debit Items" in the computation of Net Capital.

(Also see Rule 319 [¶ 2319] for debit items relating to self-insured amounts.)

Special provisions

(c) For the purpose of this special provisions section proprietary positions arising out of the bona fide conduct of market making, block positioning, or underwriting activity and held for not more than thirty days measured on a "first-in, first-out" basis and positions arising out of the bona fide conduct of specialists or arbitrage activities (including purchases and sales and sales and purchases of securities of companies involved in publicly announced mergers, acquisitions, consolidations, tenders etc.) are referred to collectively as "Current Positions" and all other proprietary positions are referred to as "Other Proprietary Positions."

Governmental Obligations

(1) In the case of obligations of:

U. S. Government Bonds

(A) The United States or any agency thereof and obligations guaranteed as to principal or interest by the United States or any agency thereof the following percentages of market value shall be deducted:

Rules of Board—Capital Requirements
 → Administered by Regulation & Surveillance.

3 5 3 3

| | Current Positions | Other Proprietary Positions |
|--|-------------------|-----------------------------|
| (i) Less than one year to maturity | 0% | 0% |
| (ii) One year but less than five years to maturity | 2% | 2% |
| (iii) Five years but less than seven years to maturity | 2% | 3% |
| (iv) Seven years or more to maturity | 3% | 3% |

Municipal Bonds

(B) A State, territory or possession of the United States or any political subdivision thereof and obligations guaranteed as to principal or interest by such State, territory, possession or political subdivision thereof or any authority, commission or agency of a State, territory or possession of the United States, or any political subdivision thereof the following percentages of market value shall be deducted:

| | Current Positions | Other Proprietary Positions |
|---|-------------------|-----------------------------|
| (i) Less than one year to maturity | 1% | 1% |
| (ii) One year but less than two years to maturity | 2% | 2% |
| (iii) Two years but less than three years to maturity | 3% | 3% |
| (iv) Three years but less than five years to maturity | 5% | 5% |
| (v) Five years or more to maturity: | | |
| —Covered by the 1st and 2nd ratings by any nationally known statistical service which is recognized by the Exchange | 5% | 5% |
| —Covered by the 3rd rating any nationally known statistical service which is recognized by the Exchange | 10% | 10% |
| —Covered by 4th rating by any nationally known statistical service which is recognized by the Exchange | 10% | 15% |
| —Covered by other ratings or not rated | 10% | 20% |
| (vi) Municipal Bond Funds regardless of time to maturity —U.S. only | 10% | 20% |
| (vii) Any of the above which is in default as to interest | 30% | 30% |

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Canadian Government Bonds

(C) The Government of Canada or any agency thereof whose obligations are unconditionally guaranteed as to principal and interest by the Government of Canada the percentages of market value to be deducted are the same as in (e)(1)(A) above.

**Common Stocks, Preferred Stocks,
Rights and Warrants**

(2)(a) In the case of common stocks, preferred stocks (other than preferred stocks on the "exempt" lists maintained by the New York Stock Exchange, Inc. and similar lists maintained by other recognized U. S. and Canadian exchanges) rights and warrants, the following percentages of market value shall be deducted:

| | Current Positions | Other Proprietary Positions |
|---|-------------------|-----------------------------|
| Listed on any recognized U. S. or Canadian stock exchange | | |
| Traded over-the-counter and generally considered as eligible for purchase on margin | | |
| Traded over-the-counter and, although not generally considered as eligible for margin, regularly quoted by three or more market makers (which may include the member or member organization whose capital position is being computed) | 30% | 30% |
| Open End Mutual Funds (U. S.) | | |

For the purposes of this paragraph (e)(2)(a) of Rule 325, an over-the-counter security shall be considered as being "eligible for margin" if the member organizations' extension of credit to customers for the purchase of identical securities would not violate the provisions of the Securities Exchange Act of 1934 or regulations issued in accordance therewith.

(b) In the case of Preferred Stocks on the "exempt" list maintained in the New York Stock Exchange, Inc. Guide at P 2394.20 and the comparable lists maintained by other recognized U. S. and Canadian Exchanges, the following percentages of market value shall be deducted.

| | | |
|------------------------|-----|-----|
| Exempt List Preferreds | 20% | 30% |
|------------------------|-----|-----|

Redeemable Securities

(3) In the case of obligations or preferred stocks which the issuer has officially declared will be redeemed within ninety days, the full market value or the cash redemption value, whichever is lower, shall be included in computing Net Worth and Net Capital.

Commercial Paper

(4) In the case of any obligation which has a maturity at the time of issuance of not exceeding nine months, exclusive of days of grace, or any renewal thereof, the maturity of which is likewise limited, the following percentages of face amount shall be deducted:

| | Current Positions | Other Proprietary Positions |
|---|-------------------|-----------------------------|
| Covered by ratings A-1, A-2 or A-3 by Standard & Poors; or | | |
| Covered by Prime rating by the National Credit Office; or | | |
| Issued by an issuer whose long term debt is covered by the first four ratings of any nationally known rating agency recognized by the Exchange: | | |
| Less than 91 days to maturity | 1/8% | 1/8% |
| 91 days but less than 181 days to maturity | 1/4% | 1/4% |
| 181 days but less than 271 days to maturity | 1/2% | 1/2% |
| Not covered by ratings as above regardless of time to maturity | 30% | 30% |

Non-Convertible Bonds

(5) In the case of interest bearing obligations which do not have a conversion or exchange feature, the following percentages of market value shall be deducted:

| | Current Positions | Other Proprietary Positions |
|--|-------------------|-----------------------------|
| Covered by the 1st, 2nd and 3rd ratings by any nationally known statistical service which is recognized by the Exchange: | | |
| Less than one year to maturity | 1% | 1% |
| One year but less than two years to maturity | 2% | 2% |
| Two years but less than three years to maturity | 3% | 3% |
| Three years but less than four years to maturity | 4% | 4% |
| Four years but less than five years to maturity | 5% | 5% |
| Five years or more to maturity: | | |
| Covered by the 1st and 2nd ratings by any nationally known statistical service which is recognized by the Exchange | 5% | 5% |

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| | Current Positions | Other Proprietary Positions |
|--|-------------------|-----------------------------|
| Covered by the 3rd rating by any nationally known statistical service which is recognized by the Exchange | 10% | 10% |
| Covered by the 4th rating (regardless of time to maturity) by any nationally known statistical service which is recognized by the Exchange | 15% | 15% |
| Covered by other rating or not rated (regardless of time to maturity) | 30% | 30% |

Convertible Bonds

(6) In the case of interest bearing obligations, which have a conversion or exchange feature, the following percentages of market value shall be deducted:

| | Current Positions | Other Proprietary Positions |
|--|-------------------|-----------------------------|
| If listed on a registered national securities exchange; or, | | |
| If unlisted and covered by the 1st, 2nd and 3rd ratings by any nationally known statistical service which is recognized by the Exchange | 30% | 30% |
| If unlisted and covered by other rating, or not rated: | | |
| Generally -- | 50% | 50% |
| But if held as the result of an underwriting participation for not more than 30 days on first-in, first-out basis, percentage deduction is | 30% | |

Exchangeable Securities

(7) In the case of securities which are exchangeable or convertible, a security sold shall be considered, in computing Net Worth, as a sale of a security held, after adjustment of the cost or proceeds of such securities for any money to be paid or received in connection with such exchange or conversion provided the security held is, without restriction other than the payment of money, exchangeable or convertible into the security sold within a period not exceeding thirty days. With respect to a case involving a longer period of time, the Exchange will consider a written application for permission to deduct a percentage of the proceeds of sale (in lieu of 30% or some other percentage of the market value of the security held).

Preferential Treatment Upon Application

(8) In the case of securities coming within the scope of any of the following clauses, the Exchange will consider a written application for

permission to deduct a lesser percentage of the market value than heretofore provided.

(A) Interest bearing obligations and serial equipment trust certificates which are to be the subject of a primary distribution but for which a published rating is not yet available;

(B) obligations of any authority, commission or agency of a State, territory or possession of the United States or any political subdivision thereof which are payable as to principal and interest solely from specified revenues and which are not in default as to interest, which have less than nine months to maturity.

(C) obligations of a State, territory or possession of the United States or any political subdivision thereof or any authority, commission or agency thereof which are not rated by any of the nationally known statistical services recognized by the Exchange.

(D) Securities with respect to which the Exchange, acting pursuant to section (b)(4)(A)(ii), shall have made affirmative marketability determinations.

Exclusion

(9) Exclusive of bona fide cash transactions for customers in issued securities and after application of current outstanding calls for margin, marks or other deposits.

Contractual Commitments

(10) Net Worth and "Debit Items" (A)(iii), (A)(iv), (B) and (C) of paragraph (b)(4) of Rule 325 should be adjusted for open contractual commitments which will include delayed delivery, underwriting and "when issued" contracts, endorsements of puts and calls and commitments in foreign currencies and spot (cash) commodity contracts but will not include open commodity future contracts and uncleared regular way purchases and sales of securities, by applying the amounts due thereon and any valuation of securities involved as though such amounts and valuations were actual, except that this treatment of any individual commitment shall not operate to increase Net Worth or Net Capital. A series of contracts of purchase or a series of contracts of sale, of a stated amount of the same security conditioned, if at all, only upon issuance shall be treated as an individual commitment and the profit, at market, in each individual commitment used to reduce the debit item (B) or (C) relating to that commitment.

Individual Accounts of Partners, Officers and Stockholders

(11) Accounts of general and limited partners in a member firm and accounts of officers and holders of stock of a member corporation other than those recording capital for purposes of this Rule, shall be considered as customers' accounts. No credit balances, securities or equities in such accounts of general partners shall be included as partnership property in computing the Net Capital of a member firm. In addition, Net Worth for purposes of this Rule shall not include the contents of such accounts of general partners. (See (c) (12) and (13) below.)

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**Accounts Covered By Agreements Approved Under Rule
326.13 and Similar Accounts**

(12) For the purposes of this Rule, accounts covered by agreements approved under Rule 326.13 and any similar accounts which are not recognized as Net Worth or Net Capital under this Rule shall be considered as customers' accounts.

**Non-Recognition of Any Securities in Partners'
Capital Accounts**

(13) No value shall be included in computing Net Worth or Net Capital under this Rule for any securities contained in partners' capital accounts.

In order to be recognized for capital purposes under this Rule, all securities contributed as capital must be contributed as collateral to a secured demand note under a secured demand note collateral agreement and a secured demand note approved by the Exchange for purposes of this Rule.

Securities Subject to Special Initial Margin Requirements

(14) In the case of member organizations whose trading shows a pattern of purchasing and selling the same listed stock on the same day, (or all member organizations when so designated by the Exchange), during the period in which any special margin requirement is in effect, the capital charge against any new proprietary transaction of members or member organizations pursuant to Rule 325 (Capital Requirements) resulting in a long or short position, shall be treated as a "contractual commitment" from the trade date to the settlement date and shall be subject to a charge to net capital of the same percentage as specified in the special margin requirement, excepting in the case of the specialist in that stock or of others who at the request of a Floor Official have participated in a difficult market situation.

Amendments.

Rule 325(c)(1), (2) and (8)(B) amended October 16, 1958, effective December 1, 1958.

Rule 325(b)(4) amended March 19, 1964, effective May 1, 1964.

Rule 325(c)(12) added October 28, 1965; amended January 20, 1966.

Rule 325(b)(4)(I) added August 18, 1968, effective December 1, 1968.

Rule 325(a) amended March 26, 1970.

Rule 325(c) (2) amended May 21, 1970.

July 15, 1971.

Rule 325(a) amended December 7, 1972.

July 11, 1974.

Rule 325(b)(4)(A)(vi) amended December 12, 1974.

*** * * Supplementary Material:****.10 Computation of net capital under Rule 325.—****Credits:****(1) "Capital"**

- (a) Credit balances in accounts for capital stock \$
(b) Credit balances in capital accounts of partner.



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